Service Date: July 12, 2006

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA PSC
* * * * *

IN THE MATTER of the Application of	)	UTILITY DIVISION
NorthWestern Energy's Electric Default	)	DOCKET NO. D2005.5.88
Supply Tracker Filing	)	ORDER NO. 6682d

FINAL ORDER

Appearances

FOR THE APPLICANT:

NorthWestern Energy

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BEFORE:

GREG JERGESON, Chairman
BRAD MOLNAR, Vice-Chairman
DOUG MOOD, Commissioner
ROBERT H. RANEY, Commissioner
THOMAS J. SCHNEIDER, Commissioner

COMMISSION STAFF:

Al Brogan, Staff Attorney
Eric N. Eck, Chief of Revenue Requirements
Kim Moran, Rate Analyst

Procedural History

1. On June 20, 2005 NorthWestern Energy (NWE) filed its electric default supply tracker filing with the Montana Public Service Commission (Commission). NWE filed this application late for the third time in three years. In Docket No. D2001.10.144, Order No. 6382d, the Commission stated: “A filing for approval of interim rates to recover electricity supply costs for the period July 1, 2003 through June 30, 2004 must be made no later than June 1, 2003.” The Commission again reminds NWE that annual electric default supply tracker filings must be filed no less than 30 days prior to the proposed effective date of the rate change (which is normally July 1st). The filing contained the following elements: 1) the electric supply deferred cost account balance for the period ending June 30, 2005 and the projected electric load, supply and related costs for the twelve month period July 1, 2005 through June 30, 2006 and 2) a request to recover costs and related lost revenues associated with Demand Side Management (DSM) programs.

2. In this filing, NWE did not assess any incremental costs or benefits due to customers leaving or returning to Default Supply. Consistent with Interim Order 6574, any incremental supply expenses due to the return of customers around July 1, 2004 were included in rates for all customers. That treatment was accepted by the PSC in order to determine interim relief in this Docket.

3. On June 10, 2005 the Commission issued a Notice of Commission Action which denied without prejudice NWE’s Motion for a Protective Order.

4. On June 27, 2005 the Commission issued a Notice of Application and Intervention Deadline.

5. On July 19, 2005 the Commission issued a Notice of Staff Action granting intervention to the Montana Consumer Counsel (MCC) and the Montana Large Customer Group (LCG).

6. On July 28, 2005 the Commission issued Procedural Order No. 6682 which established among other deadlines a hearing date in this Docket on January 4, 2006.

7. On August 29, 2005 NWE renewed its Motion for a Protective Order.

8. On September 13, 2005 the Commission approved Protective Order No. 6682a.

9. On October 3, 2005 NWE filed a revision to its Electric Default Supply Tracker which was originally submitted on June 20, 2005. The original filing was delayed because of issues relating to issuance of and compliance with the Protective Order in this Docket. NWE updated its original filing with more recent information. The update reflected actual information for the months of May through August 2005 and the projected electric supply costs based on currently available information.

10. On October 13, 2005 the Commission approved Interim Order No. 6682b. NWE was authorized to implement, on an interim basis, rates designed to increase annual jurisdictional electric supply revenues from $247,417,000 to $276,773,736 which was an increase of $29,356,736 over then present rates. The revenue increase excluded the $1,002,015 allowance for lost Transmission & Distribution (T&D) revenues and included the incremental costs of customers returning to default supply. The revenue increase was reduced by the overcollection of $5,189,223 at the end of June 2005. This resulted in a net increase of $24,167,513 for the 2005/2006 tracking period.

11. On October 25, 2005 the Commission issued Procedural Order No. 6682c which established among other deadlines a hearing date in this Docket on March 8, 2006.

12. On November 22, 2005 the MCC filed the prefiled direct testimony of Dr. John W. Wilson. The Montana LCG did not file testimony in this Docket.

13. On January 13, 2006 NWE filed the rebuttal testimonies of: Mr. John Hines; Mr. Bryan Bradshaw; Mr. Frank Bennett and Mr. William Thomas.

14. On January 20, 2006 the Commission issued a Notice of Public Hearing. The Notice stated that the hearing would commence on Wednesday, March 22, 2006 at 9:30 a.m., in the

Bollinger Room, 1701 Prospect Avenue, Helena, Montana, and that it might continue from day to day until concluded.

15. MCC filed its prehearing memorandum on March 2, 2006 NWE filed its prehearing memorandum on March 2, 2006 and the Montana LCG filed its prehearing memorandum on March 6, 2006.

16. On March 21, 2006 NWE filed a Stipulation and Agreement between the Company and MCC. A copy of the Stipulation is attached to this Order as Appendix A.

17. The hearing in Docket No. D2005.5.88 was held March 22, 2006.

18. In a letter dated June 12, 2006 submitted in Docket No. D2006.5.66, NWE indicated that the estimate for lost Transmission and Distribution revenues had declined by $81,766 from $1,002,015 to $920,249. The Commission takes administrative notice of that revision to the lost revenue estimate.

19. On June 26, 2006 NWE filed an Addendum to the Stipulation and Agreement between the Company and MCC. A copy of the Addendum is attached to this Order as Appendix B.

Summary of Stipulation and Agreement and Addendum

20. The Parties agreed that the Basin Creek projected dispatch volumes and the estimated costs of projected short-term purchases associated with this dispatch during the 2005/2006 tracking period are uncertain. However, in view of the fact that actual Basin Creek dispatch volumes will be known and reflected in monthly true-ups within a short period of time, no adjustment or disallowance is required in this case. NWE agreed to develop a dispatch model that will be used to estimate future dispatch volumes for the Basin Creek facility. The Parties agreed that these issues were settled for purposes of this Docket.

21. The MCC did not make a recommendation of imprudence or non-recovery of short-term purchases in this tracker with respect to the short-term/long-term mix of resources in the portfolio for the 2005/2006 tracker period. The Parties agreed that it is important for NWE to expeditiously pursue its efforts to secure firm economic default supply resources, within an efficient resource mix.

22. The MCC accepted that the Monday peak price NWE paid for the PPL Sunday purchases was less than the Sunday mid-Columbia spot price plus likely associated wheeling

and transmission loss costs and that there should be no cost disallowance in this case for these purchases. The Parties agreed that this issue is settled for purposes of this Docket.

23. In regard to the sales for future delivery made to Avista in January of 2003, the Parties agreed: (a) NWE shall be financially responsible for all replacement costs associated with these sales for the 2005/2006, 2006/2007, and 2007/2008 tracking periods; (b) NWE shall be allowed to recover replacement costs associated with these sales for the 2004/2005 tracker period; (c) NWE has recovered replacement costs associated with these sales for the 2003/2004 tracker period and (d) these issues are settled for purposes of this Docket.

24. On June 26, 2006 NWE filed an Addendum to the Stipulation and Agreement between the Company and the MCC. The Addendum presents the agreement of NWE and the MCC on the procedure for removing and accounting for certain revenues and expenses associated with the January 2003 Avista sales from this electric tracker. An attachment to the Addendum indicated that $2,528,488 of revenues and $4,170,252 of purchased power expenses were determined by the parties to be the correct values to be eliminated from the tracker.

25. After the Stipulation between the MCC and NWE was filed, the following issues remained in this Docket:

1. Whether NWE’s performance based DSM service contracts are reasonable in conjunction with a lost revenue adjustment mechanism;
2. Whether NWE’s proposed DSM Staff labor cost adjustment is reasonable and appropriate for this tracker filing; and
3. Whether NWE has reasonably estimated lost Transmission and Distribution (T&D) revenues attributable to DSM that it proposes to charge default supply customers.

Performance-Based DSM Service Contracts

26. NWE contracted with KEMA, Inc. to provide lighting program services for both commercial and residential customers. The E+ Commercial Lighting Program was moved from Universal System Benefits (USB) funding to DSM funding. The basis of an expanded lighting program is an offer of cash rebates for Energy Star qualified compact fluorescent

lamps (CFL) and indoor/outdoor fixtures. The goal for CFLs for the calendar year 2005 is 180,000 units. NWE, in consultation with KEMA, will review the results, successes, and failures of the first year of program activity and incorporate the most successful elements into its 2006 Energy Efficient Lighting Program.

27. In July 2005 NWE moved E+ Business Partners from USB to DSM funding. NWE is in discussions with two outside service providers to perform work to increase customer interest in the program. NWE expected to finish an agreement by August 2005. Also, NWE staff will work to increase participation in the program through direct contact with larger commercial customers and development of customized, site-specific projects.

28. In December 2004 NWE contracted with the National Center for Appropriate Technology (NCAT) to evaluate the potential for electricity savings from commercial rooftop Heating Ventilating Air Conditioning (HVAC) units (RTUs). The goals of the evaluation are to identify the market for RTU operation changes that increase electrical energy efficiency, identify enhanced RTU maintenance programs and costs and identify potential for RTU replacement to improve overall RTU electrical efficiency. The first phase of the contract is complete. In phase II NCAT will select a representative sample of 100 RTUs . Servicing, maintenance and repair work will be performed as needed, and in some cases inefficient or badly damaged RTUs will be replaced with new, more efficient units. NCAT will provide NWE with findings on costs, benefits and DSM potential from RTUs in December 2005. NWE will review the findings and recommendations and incorporate them into a Commercial HVAC DSM program in 2006.

29. Dr. Wilson reviewed DSM program costs for the 2004/2005 and 2005/2006 tracker years. In the original filing DSM costs for the 2004/2005 tracker were estimated to be $575,305. In the revised filing the estimated DSM costs were reduced to $320,392. DSM costs for the 2005/2006 tracker year were estimated to be $3.7 million in the original filing, in the revised filing the estimated DSM costs were reduced to $3.2 million. The estimated DSM costs for the 2005/2006 tracker year are subject to an annual true-up.

30. Dr. Wilson believes that DSM program cost recovery is generally reasonable. However, there is a significant cost component which should be considered carefully. NWE has contracted with Royal Consulting Incorporated (RCI) to recruit and develop E+ Business Partners and E+ Commercial Lighting Rebate projects and with the National Center for

Appropriate Technology (NCAT) for the same work. Compensation to both RCI and NCAT is performance-based. RCI will be paid on a performance-based incentive at 15 percent of the electric conservation resource value for completed non-lighting Business Partners projects and 10 percent of the electric conservation resource value for completed E+ Commercial Lighting Rebate projects. NCAT will be paid on a performance-based incentive at 22 percent of the electric conservation resource value for completed non-lighting Business Partners projects and 18 percent of the electric conservation resource value for completed E+ Commercial Lighting Rebate projects.

31. Performance-based compensation tends to undermine the objectivity of estimating true conservation achievements. Both NWE and the contractors have a strong economic incentive to report robust results — the contractor to maximize compensation and NWE to maximize the lost revenue estimates that it proposes to include for recovery as a tracker cost (in this case $1 million in 2005/2006, with substantial escalation in subsequent years, as each year's estimated revenue loss is assumed to accumulate with further conservation in future years).

32. While NWE indicates it will oversee and evaluate the contractor's performance with regard to these incentives payments, any challenge that it makes to the contractor's claimed conservation resource value would result in a reduction of NWE's own lost revenue compensation.

33. Dr. Wilson is concerned that the use of performance-based contracts for DSM service providers presents both NWE and its DSM contractors with an incentive to inflate DSM savings estimates. He argues that NWE cannot be an objective administrator of these contracts in their present form. Mr. Thomas does not agree with Dr. Wilson for several reasons. The NWE staff responsible for reviewing DSM Projects submitted by contractors is qualified, honest and diligent. Each project proposal and installation report, and the associated energy savings calculations, will be thoroughly reviewed by a NWE DSM engineer who holds a registered professional engineer certificate. This person will make his recommendations on approval and payment to contractors will carry the weight of his technical expertise, 13 years of work experience specific to DSM programs and projects, and adherence to the ethics and rules of conduct required to maintain his professional license.

34. Contractors will be watched carefully, and they recognize that their primary incentive is continued employment under contract to NWE. Sustaining the business will require that contractors deliver quality DSM projects that pass NWE's review. If contractors attempt to inflate energy savings it will be detected and will eliminate or seriously compromise their prospects for future DSM work with NWE.

35. The Commission's Order No. 6574e in Docket No. D2004.6.90 provides for a true-up of recovered lost revenues based on the results of a comprehensive DSM Program evaluation. If the program evaluation identifies DSM projects with unreasonably high energy savings estimates, then the overage and associated lost revenues will be deducted in the true-up calculation. It serves NWE's long-term interest to conduct a transparent DSM program based on defensible energy savings estimates. NWE's incentive is to maintain this or some other suitable means for cost recovery, including lost revenues, over the 20-year term of its DSM Program. NWE is not motivated to game the system in the short-term using performance-based contracts as suggested by Dr. Wilson, and risk loss of its means to recover lost revenues.

36. NWE asked MCC in Data Request NWE – 001 to recommend alternative approaches to performance-based compensation and explain why such alternative approaches were preferable and how they could provide a similar level of motivation for the contractors. In its response MCC simply declared "least fixed cost contracts or justifiable cost recovery contracts" to be preferable, but made no effort to explain what they are, how they work, or why they are preferable. It is unclear what MCC has in mind. NWE believes that the performance-based contracts, with appropriate safeguards are an effective means of motivating contractors to perform well against aggressive DSM goals. If contractors cannot deliver DSM projects that pass muster, they will not get paid and they risk cancellation of their contracts.

37. Energy savings are determined through a modeling process. When the contractor submits a project to NWE for approval, a computer energy use simulation on the building is done in order to determine the projected energy savings. Contractors are required to use a software modeling system to perform this analysis which is compliant with the United States Department of Energy's DOE Version 2 model, which is the industry standard. Once the project is submitted to NWE, it is checked to insure accuracy. Further, NWE will include

projects under these contracts in the comprehensive DSM program evaluation included in Order Nos. 6496f and 6574e. That Order provided: "The estimated lost transmission and distribution-related revenue from demand-side resource acquisition for the 2004-2005 tracking year must be trued-up following a comprehensive program evaluation to verify savings. NorthWestern Energy must file with the Commission on or before June 15, 2007 the results of a comprehensive evaluation, performed by an independent third party, of all demand-side management programs that verifies savings produced by the programs for the evaluation period. NorthWestern Energy must consult with its advisory committee on the selection of the independent evaluator and the proper scope of work."

38. In its Initial Brief, NWE stated: "The individual whose responsibility it is to review the projects is a professional engineer. His professional ethics and the requirements of his license require him/her to act in a professional manner and not game the system to promote projects that are inappropriate. The contractors also have an incentive to perform. To continue employment in this capacity with NWE, their job performance must be satisfactory. If it is not and NWE discovers problems, the project proposal will be rejected and the contract may be discontinued. Finally, and perhaps most importantly, in the Order the Commission has authorized NWE to use its methodology to recover lost T and D revenues. NWE will not jeopardize the trust it is attempting to establish with the Commission for some short-term gain. It is clear that the process that is being incorporated by NWE is designed to insure that the energy savings upon which the contractor's compensation is to be based is as accurate as possible."

39. NWE noted that Dr. Wilson suggested that a better method would be to pay contractors on the basis of the cost that is incurred in the work that they do on a competitive basis. The Company explained that the inception of performance-based contracts was based upon NWE's experience with the Business Partners program, which has been in existence over the past several years. The program used a mechanism similar to that being advocated by Dr. Wilson — payment from NWE based on costs incurred by customers for identifying, evaluating and installing DSM measures. The program's participation fell off to the point where it had died. (Tr. p. 58, lines 3-10). NWE's Performance Based Contracts are designed to encourage contractors to go out and solicit customers and overcome a barrier of apathy

and recalcitrance that caused the demise of the Business Partners Program. (Tr. p. 58, lines 11-16).

40. NWE warned that the consequences of unwinding these contracts now are dire. They are now effective through December 31, 2006. Termination will trigger language in the contracts requiring NWE to compensate the contractors for their incurred costs to date, which would aggregate to approximately $150,000. The current methodology of the contracts places the risk on the contractors to get the projects identified, committed and approved in order to cover the costs they've already incurred. NWE urged the Commission to review the compensation methodology at the time it reviews the lost T and D revenue recovery mechanism, and give the Performance Based Contracts approach an opportunity to prove its worth. If the Commission were to approve the methodology on this temporary basis, NWE would consider these contracts' renewal based upon performance of the contractors. The use of performance based contracts and the use of lost Transmission and Distribution revenues adjustment will be completely evaluated in the third party review which will be filed by June 15, 2007. The independent review should determine what the best methods are for dealing with DSM issues on a forward looking basis.

41. In its Response Brief MCC argued that: "While NWE indicates that it will oversee and evaluate consultant performance as regards these incentives payments, any challenge that it makes to the consultants' claimed conservation resource value would result in a reduction of NWE's own lost revenue compensation. This quite clearly creates a situation in which there is diminished incentive for NWE to critically evaluate consultant performance and limit expenditure to true achievement, and one in which both parties have a strong incentive to maximize the estimated performance and thus inflate customer charges." MCC stated: "Even if the Commission agrees with this cost argument it should still direct that there should be no further contracts of this type and it should cap recoverable contractor payments under the two existing "incentive" contracts at no more than the $150,000 cost that would be incurred to terminate them."

42. In its Reply Brief NWE stated that the Company has taken extraordinary steps to insure that its review process is critical and transparent. Modeling systems used by the contractors to determine energy savings from the Business Partners DSM projects are U.S.

Department of Energy compliant. A Professional Engineer at NWE reviews the modeling to insure its accuracy and veracity.

43. This process will be reviewed as part of the comprehensive DSM program evaluation which will be conducted by an independent third party and presented to the Commission when NWE trues up its estimates as required by Final Order No. 6574e in Docket No. D2004.6.90.

44. MCC advocates the use of cost-based contracts for this DSM program. That method according to NWE has been tried in the Business Partners program and it has failed. The performance-based contracts create an incentive for contractors to aggressively solicit customers and implement the DSM programs. If they are successful they are compensated. The methodology deserves a chance to prove its worth through the review to be conducted and presented to the Commission.

NWE's Proposed DSM Staff Labor Cost Adjustment

45. NWE stated that $96,239 of its 2004/2005 DSM program expense was for NWE staff labor. In its response to Data Request MCC – 026, the Company indicated that replacing estimates for May and June with actual costs reduced the staff labor cost to $88,501. Also in the same response NWE agreed with Dr. Wilson that $36,431 of staff labor expense was reflected in previously authorized rates for T&D service and as a result should not be included in the tracker. The transmittal letter in the revised filing indicated that the testimony and exhibits of William Thomas had not been revised as part of the updated filing, however updates to DSM program expenditures for the months of May and June 2005 were provided in response to Data Request MCC – 022. The DSM labor expenses were adjusted to reflect the elimination of the portion of DSM related labor already included in T&D rates as shown in Response to MCC – 026. Mr. Bennett's testimony and exhibits in the revised filing reflect the DSM updates as shown in the responses to MCC Data Requests.

46. According to Dr. Wilson there are several reasons why the Commission should deny the request to charge any of these labor costs to ratepayers as an additional revenue requirement. First, the staff position referred to by NWE (e.g. Program Coordinator rather than Program Director), is not really a new role for company personnel. Second, these kinds of intermittent increments and decrements to staff positions and other cost changes between

rate cases are simply inappropriate for tracker type adjustments. NWE is attempting to single-out one cost component that has increased and ignored offsetting changes that have reduced expenses.

47. Dr. Wilson examined NWE's 10K reports for 2002 and 2004. On December 31, 2002, NWE had 1,488 employees in its electric and gas utilities business in Montana (that was down from about 2,000 employees at the time of the Montana Power Company's last rate case). In contrast, by December 31, 2004, NorthWestern had 1,007 Montana employees. It is inconsistent with long established test year ratemaking principles, as well as one-sided and unfair to consumers, to attempt to increase rates between rate cases to account for employee additions but to make no corresponding adjustments for employee reductions. Such a procedure will motivate regulated utilities to avoid and delay critically important general rate cases in which all revenues and expenses in a test year are examined.

48. In its Initial Brief, NWE explained that it envisioned a DSM Program Coordinator position that would be solely dedicated to the acquisition of DSM resources for the default supply portfolio. As such, the labor charges are properly considered to be part of the overall cost of DSM and recoverable through the default supply tracker. In the past the Commission has authorized NWE to recover labor spent on USB activities from USB funds. This is analogous to what NWE is requesting in this case.

49. NWE noted that the MCC is critical of this approach, asserting that this position is really not a new staff position and, further, changes to staff positions are not appropriate for tracker-type adjustments. Essentially, the MCC argues that NWE's employee numbers have dropped dramatically over the years and to account for employee additions without a corresponding adjustment for the elimination of positions is unfair. The inclusion of the costs of the Program Coordinator, which are solely dedicated to acquisition of DSM, properly belong in the tracker.

50. MCC in its Response Brief argued that the DSM Program Coordinator is really not a new one for company personnel. And even if this were a new position added since the Company's last rate case, it would be plainly abusive and unfair to ratepayers to add the cost of one such added employee but fail to recognize the cost savings of all the employee reductions that have occurred since the last rate case.

51. In its Reply Brief NWE stated that the evidence on the record refutes the MCC's argument. When Mr. Thomas was questioned about NWE's previous attempts at establishing a DSM Program Director, he was asked: "So Mr. Hauser took over your DSM program responsibilities?" Mr. Thomas answered: "He did for a time. He was there perhaps a couple of years. And then as I recall, that function went away and the Company, back in those days, actually was more in a marketing mode. He moved into market research. I think that that particular position was–either went away or was reabsorbed into some other job. It's only been much more recently since a DSM Program Coordinator position proper has been created incrementally to respond to the need to pursue DSM resources as a contribution to the portfolio. And that's why we think the cost, the labor costs associated with that are specific to and for the purpose of getting the DSM resource and its part of the cost of that acquisition." (Tr. p. 23 line 21 to p. 24 line 11).

Whether NWE Has Reasonably Estimated DSM Lost Revenues

52. In its Initial Brief NWE stated that Dr. Wilson did not feel that NWE's estimates of lost DSM revenues are reasonable. If the estimates are found to be reasonable Dr. Wilson conceded that they would be recoverable pursuant to the Commission's subsequent evaluation as provided in Order No. 6574e. Dr. Wilson found that NWE's procedures and estimates are not reasonable because the procedure "…simply involves allocating a percentage of a total potential number that was determined four years ago to various programs…" (Tr. p. 106, lines 17-21). Dr. Wilson recommends "building up to estimates rather than allocating an estimate down from an aggregate." (Tr. p. 109, lines 1-3).

53. According to NWE Dr. Wilson's testimony reflected a misunderstanding of the formula used to compile electric energy savings potential and annual DSM targets that are used in the lost revenue recovery mechanism. Contrary to the assertions of Dr. Wilson, the methodology builds energy savings estimates from the bottom up, moving from specific DSM measures to overall DSM total potential. DSM potential was analyzed measure-by-measure, then building type-by-building type for individual categories of residential and commercial facilities, to build a total DSM potential number of approximately 100 aMW. The Default Electric Supplier Procurement Guidelines (ARM 38.5.8218(4)) state: "A DSU should develop and strive to achieve targets for steady, sustainable investments in cost-

effective, long-term demand-side resources." On that basis, NWE converted this 100 aMW into annual DSM targets or goals over a 20-year period, and individual DSM programs were assigned a portion of the annual goal based on their respective proportionate contributions to the total DSM potential of 100 aMW. This approach to estimating DSM potential and developing program targets is based on sound analytical methods, and is not one of "…very loosely backing into some estimates…" as incorrectly characterized by Dr. Wilson (Tr. p. 84, lines 19-20).

54. MCC testimony ignores the fact that the Lost Revenue Adjustment mechanism has a self-correcting feature, or true-up, incorporated into the calculation methodology. Annual DSM targets are used as a basis to estimate lost revenues prospectively, and then one year later those adjustments are corrected using reported DSM program savings. Subsequent program evaluations performed by an independent third party and designed to determine actual program savings (to the cost-effective level of accuracy supported by current evaluation technologies and techniques) will, among other things, determine whether future adjustments to historical and forecast estimates of program savings and therefore lost revenue are appropriate. Those adjustments could be up or down. NWE will contract for and complete such evaluations on a schedule as required by the Commission's Final Order No. 6574e.

55. Further, NWE already applies factors to both its forecast and reported program savings in recognition that actual program savings may, for various reasons, be less than reported savings. As a result, currently, lost revenues are calculated based on 80 percent and 70 percent (the adjustment factors) of the reported residential and commercial program savings respectively. The adjustment factors are based on Montana Power Company's past DSM experience and, while they are likely not entirely representative of today's programs, NWE firmly believes that they are fair and reasonable proxies until the program evaluations described above are completed. The evaluations will result in updated adjustment factors upon which the lost revenue adjustments to historical and forecast program savings and lost revenues should be based.

56. In its Response Brief MCC argued that although KEMA may have developed energy savings from the bottom up, clearly NWE has not done so in this case to estimate DSM lost revenues. Indeed, in the Company's Brief it was stated: "NWE converted [KEMA's] 100

aMW into annual DSM targets or goals … and individual DSM programs were assigned a [proportionate] portion of the annual goal." (NWE Initial Brief p. 9). This is precisely the simple allocation of a gross DSM potential (that was estimated based on entirely different assumptions than those underlying NWE's actual DSM program) as described by Dr. Wilson.

57. MCC's position is that the Commission should not authorize recovery of the lost revenue amounts that NWE has proposed for inclusion in rates in the 2005-2006 tracker year at this time. The disallowance of such unreasonably estimated amounts at this time is particularly important because it is questionable whether consumers will be adequately protected against such rate excesses through a subsequent "true-up." As Dr. Wilson explained, this is in part attributable to the monetary incentives inherent in NWE's DSM program design and in part attributable to the fact that "true-ups" themselves will really be nothing more than estimates, and even those estimates are likely to be biased. (Tr. p. 77, line 23 to p. 79, line 21).

58. In its Reply Brief NWE states that MCC's argument engages in semantics. It its Order the Commission found it reasonable and in the public interest to implement NWE's lost transmission and distribution revenues recovery mechanism. The Response Brief reflects MCC's continuing misunderstanding of the procedure. As noted in NWE's Initial Brief, DSM potential was analyzed measure-by-measure, then building type-by building type for individual categories of residential and commercial facilities, to build a total DSM potential number of approximately 100 aMW. This number was converted into annual DSM targets over a 20-year period. Individual DSM programs were assigned a portion of the annual goal based on their respective proportionate contributions to the total DSM potential of 100 aMW. The approach is sound and has a concrete analytical basis in an area wherein all parties agree that rock solid figures are unavailable. After this analysis has been completed, NWE discounts the DSM savings estimates by 20 to 30 percent such that only 70 to 80 percent of the estimated lost revenues are included in customer's rates. After all of these steps, these figures will then be trued-up at a later date. Once the program has been implemented and the results of the third party evaluation are available, NWE will welcome any further consideration of this issue.

Commission Discussion and Analysis

Stipulation Agreement of NWE and the MCC

59. The Commission will make several brief comments about sections 2, 3, 4 and 5 of the Stipulation and Agreement indicating how it views the resolution of those items. MCC raised concern with the projected dispatch volumes of the Basin Creek project in this Docket. The Commission agrees with the parties that actual Basin Creek dispatch volumes will be known and reflected in monthly true-ups within a short period of actual project dispatch. Given those frequent true-ups, no adjustment is required in this Docket. NWE agreed to develop a dispatch model that will be used to estimate future dispatch volumes for the Basin Creek project. The Commission does not object to NWE attempting to develop a dispatch model for the Basin Creek project, but is skeptical of how accurate the model will be given the enormous volatility of both the electricity and natural gas markets, both of which will impact the dispatch of the Basin Creek project. In future annual tracker periods the Commission does not expect the projected dispatch of the Basin Creek project to be further argued by the parties. Given the impact of monthly true-ups, any deviation from the projected Basin Creek dispatch in the twelve-month look forward period will be quickly and efficiently dealt with.

60. Section 3 dealt with the mix of short-term/long-term mix of resources in the default supply for the 2005/2006 tracker period. The parties agreed that it is important for NWE to expeditiously pursue its efforts to secure firm economic default supply resources, within an efficient resource mix. In its Initial Brief NWE commented that the Procurement Rules promulgated by the Commission do not set forth a preferred percentage of short-term purchases. Currently, NWE has approximately 75 percent of its current portfolio in fixed price contracts. This affords a substantial measure of price stability to consumers (if prices move upward) while providing an opportunity for consumers to benefit if market prices move below the average of fixed price contracts. NWE stated that the current portfolio mix is well balanced to cover NWE's load requirement. Dr. Wilson opined on the level of short-term resources at the hearing: "My own opinion is that 25 to 30 percent short-term spot market exposure is pretty high… at least from my perspective, I'm not at the point where I am recommending an imprudence disallowance because of that mix at the present time. But

in my opinion, the short-term exposure is high and it has been expensive in recent months." (Tr. p. 97, lines 9-16). The Commission agrees with the parties that no adjustment should be made in this Docket to penalize NWE for having too much spot market exposure in the portfolio. However, the PSC agrees with Dr. Wilson that 25 to 30 percent short-term spot market exposure is higher than is optimal. The Commission prefers that NWE move aggressively to less reliance on the short-term spot market as it completes the default supply portfolio.

61. The Commission accepts the parties' position that no adjustment is warranted for these purchased power costs in this Docket.

62. With respect to the sales for future deliveries made to Avista in January of 2003, the Commission accepts the resolution of this issue by the parties. NWE recovered the replacement costs associated with these sales for the 2003-2004 and 2004-2005 tracker periods. NWE will be financially responsible for all replacement costs associated with these sales for the 2005-2006, 2006-2007 and 2007-2008 tracking periods. In its Initial Brief MCC indicated that the parties were still engaged in discussions regarding the replacement purchase costs that should be assigned to these sales for the first half of the 2005-2006 tracker year. On June 26, 2006 NWE filed an Addendum to the Stipulation and Agreement. The Addendum resolved the procedure for removing revenues and expenses associated with the January 2003 Avista sales from the Tracker.

63. The Commission accepts the Stipulation and Agreement and the subsequent Addendum between the MCC and NWE. The agreement represents agreements on a number of issues, and the Commission commends the parties for their efforts to reach agreement on those issues. The Commission finds that the agreement is in the public interest.

DSM Issues

Performance-Based DSM Service Contracts

64. On November 22, 2005 the MCC filed the prefiled direct testimony of Dr. Wilson. On December 14, 2005 the Commission approved Order Nos. 6496f and 6574e. The MCC did not file a Motion for Reconsideration on Order Nos. 6496f and 6574e. Due to the timing

of the Commission Order, Dr. Wilson and the MCC did not have knowledge of the Commission decisions relating to DSM issues. The Commission incorporates those Orders into this Order by reference.

65. Prior to commenting on the three contested issues, the Commission sets forth its policy with regard to the acquisition of DSM as a resource for the default supply. As evidenced by previous Commission orders and by the Electric Default Supply Planning Rules the Commission supports the acquisition of cost effective DSM resources. The goal of 100 aMW of DSM which NWE is pursuing represents an extremely cost effective resource. The nominal cost of this resource has been estimated to be $21 per MWH in nominal terms. The Commission is unaware of any competing resource which can be acquired for a cost anywhere near that price. NWE's recent Electric Default Supply Resource Planning and Procurement Plan Docket N2005.12.172 showed DSM of 100 aMW at a levelized cost of about $20 per MWH. The Commission has approved the recovery of lost Transmission and Distribution revenues until an independent third party review of NWE's DSM programs has been submitted to the Commission on or before June 15, 2007. Finally, the Commission finds acceptable the use of a modeling process to determine energy savings. As NWE noted, contractors are required to use a software modeling system to perform this analysis which is compliant with the United States Department of Energy's DOE Version 2 model, the industry standard. Once the project is submitted to NWE, it is checked to insure accuracy. Further, NWE will include projects under these contracts in the comprehensive DSM program evaluation required in Order No. 6574e.

66. Turning to the issue of whether NWE's performance-based DSM service contracts are reasonable, the Commission notes at the outset that there will not be a change in policy with regard to this issue at this time. NWE points out that language in the contracts requires the Company to compensate the contractors for their incurred costs to date, which would aggregate to approximately $150,000. Continuing with the contracts which expire on December 31, 2006 places the risk on the contractors to get the projects identified, committed and approved in order to cover the costs that they've already incurred. The Commission finds that the current contracts should continue. To halt these contracts at this time would force NWE to make payments without requiring performance by the contractors. That is an outcome which is obviously not in customers' interest. The results of those contracts and the

performance of the contractors will be reviewed during the independent third party evaluation of NWE's DSM programs. MCC requested that the Commission cap recoverable contractor payments under the existing "incentive" contracts at no more than the $150,000 cost that would be incurred to terminate them. (Response Brief p.5). The Commission declines to cap these contracts at this time. When the independent evaluation of NWE's DSM is conducted a true-up of recovered lost revenues will be made.

67. Dr. Wilson does not support the use of performance-based contracts; instead, he recommends the use of least fixed cost contracts or justifiable cost recovery contracts. The Company explained that performance-based contracts had their inception based upon NWE's experience with the Business Partners program, which has been in existence over the past several years. The program used a mechanism similar to that being advocated by Dr. Wilson. The program's participation fell off to the point where it had died. (Tr. p. 58, lines 3-10). NWE's performance-based contracts are designed to encourage contractors to go out and solicit customers and overcome a barrier of apathy and recalcitrance that caused the demise of the Business Partners Program.

68. MCC argued that: "While NWE indicates that it will oversee and evaluate consultant performance as regards these incentive payments, any challenge that it makes to the consultants' claimed conservation resource value would result in a reduction of NWE's own lost revenue compensation. This quite clearly creates a situation in which there is diminished incentive for NWE to critically evaluate consultant performance and limit expenditure to true achievement, and one in which both parties have a strong incentive to maximize the estimated performance and thus inflate customer charges." (MCC Response Brief p. 4).

69. The Commission notes Dr. Wilson's concerns about performance-based contracts. However, the use of modeling systems that are U.S. Department of Energy compliant by both the consultants and a Professional Engineer employed by NWE reduce concerns about these contracts. The independent third party review provides further assurance that performance-based contracts will be carefully examined to ensure that claimed energy savings are in fact being achieved. NWE's technical advisory committee should oversee the selection of the third party. If the third party review shows that energy savings estimates have been inflated, there will be a true-up and a reduction to the claimed lost revenues. Further, such a result will put future contracts with NWE at great risk. The Commission expects NWE to use these

contracts to acquire the targeted DSM resource, but to do so in a manner that uses modeling to achieve actual savings which closely match the original estimates. Gaming of DSM savings by NWE or consultants it contracts with will not be tolerated by the Commission. In the independent third party review of DSM activities, the use of performance based contracts will be reviewed. NorthWestern Energy must consult with its advisory committee on the selection of the independent evaluator and the proper scope of work.

NWE's Proposed DSM Staff Labor Cost Adjustment

70. In its original filing NWE included $96,239 in its DSM program expense to fund the staff position of DSM Program Director. In its response to Data Request MCC – 26, NWE indicated that replacing estimates for May and June with actual costs reduced the staff labor cost to $88,501. Also, in the same response NWE agreed with Dr. Wilson that $36,431 of staff labor expense was reflected in previously authorized rates for T&D service and as a result should not be included in the tracker. In the updated filing in this Docket Mr. Bennett's testimony and exhibits in the revised filing reflect the DSM updates as shown in the responses to MCC Data Requests.

71. The MCC made two arguments against including staff labor costs for the position of DSM Program Director. The first argument was that this position is not really a new role for company personnel. At the hearing Mr. Thomas explained that Mr. Hauser took over DSM responsibilities for a time, but he then moved into market research. Mr. Thomas stated "It's only been much more recently since a DSM Program Coordinator position proper has been created incrementally to respond to the need to pursue DSM resources as a contribution to the portfolio." At the hearing Mr. Thomas explained that Mr. Hauser took over DSM responsibilities for a time, but he then moved into market research. Mr. Thomas stated "It's only been much more recently since a DSM Program Coordinator position proper has been created incrementally to respond to the need to pursue DSM resources as a contribution to the portfolio." (Tr. p. 24, lines 3-7). The Commission finds that the position of DSM Program Director is a recent, incremental addition to NWE.

72. The second argument put forth by Dr. Wilson had to do with the large decrease in employee levels since MPC's last general rate case. At the time of the last rate case MPC had 2000 employees. In contrast, by December 31, 2004 NorthWestern had 1,007 Montana

employees. MCC argued that it is inconsistent with long established test year ratemaking principles to attempt to increase rates between rate cases to account for employee additions but to make no corresponding adjustments for employee reductions. NWE stated that the position would be solely dedicated to the acquisition of DSM resources for the default supply portfolio. Labor costs for other employees involved in acquiring default supply resources are not included in electricity supply costs. The Commission finds that the labor charges associated with the DSM Program Coordinator should not be recovered through the electric tracker. Rather those costs should be considered in a general rate case. NWE's request to include labor expense of $52,070 for the position of DSM is not approved for inclusion in this electric tracker. NWE is free to file for approval of the labor expense associated with the DSM Program Coordinator in its next general rate case.

Whether NWE Has Reasonably Estimated DSM Lost Revenues

73. Dr. Wilson took issue with how NWE developed reasonable estimates of DSM lost revenues. Dr. Wilson does not think that simply allocating a percentage of the total number that was determined four years ago to various programs is an adequate way of estimating lost revenues. MCC urged the Commission to not authorize recovery of lost revenue amounts proposed by NWE to be included in rates in the 2005-2006 tracker year at this time. NWE noted that the methodology used to compile electric energy savings potential builds energy savings estimates from the bottom up, moving from specific DSM measures to overall DSM total potential. DSM potential was analyzed measure-by-measure, then building type-by-building type for individual categories of residential and commercial facilities, to build a total number of approximately 100 aMW. NWE noted that The Default Electric Supplier Procurement Guidelines (ARM 38.5.8218(4)) state: "A DSU should develop and strive to achieve targets for steady, sustainable investments in cost-effective long-term demand-side resources." On that basis NWE converted this 100 aMW into annual DSM targets or goals over a 20-year period, and individual DSM programs were assigned a portion of the annual goal based on their respective proportionate contributions to the total DSM potential of 100 aMW. NWE noted that MCC ignored the fact that the Lost Revenue Adjustment has a self-correcting feature, or true-up, incorporated into the calculation methodology. There will be a subsequent program evaluation performed by an independent third party which will

assess actual program savings. That evaluation will determine whether future adjustments to historical and forecast estimates of program savings and therefore lost revenues are appropriate. Those adjustments could be up or down. NWE already applies factors to both its forecast and reported program savings in recognition that actual program savings may, for various reasons, be less than reported savings. Currently, lost revenues are based on 80 percent and 70 percent (the adjustment factors) of the reported residential and commercial program savings respectively. The independent evaluation will result in updated adjustment factors upon which the lost revenue adjustments to historical and forecast program savings and lost revenues should be based. The Commission does not agree with the MCC that NWE has simply developed lost revenue estimates using a top down allocation method. NWE explained that energy savings estimates were built from the bottom up, measure-by-measure then building type-by-building type. As to the MCC's complaint that the DSM potential of 100 aMW that was determined four years ago, the Commission notes that the DSM potential of 100 aMW has been reconfirmed by NWE's Electric Default Supply Resource Planning and Procurement Plan filed in Docket No. N2005.12.172 which was filed with the Commission of January 12, 2006. Finally, the Commission believes that the evaluation of the DSM programs by an independent third party is a reasonable way to ensure that actual energy savings are properly determined. The Commission is very comfortable with the ratemaking concept of true-ups having used this mechanism successfully for years in both electric and natural gas tracker filings. The Commission approves lost revenues in this Docket in the amount of $920,249.

74. In the report by the independent third party to be filed with the Commission by June15, 2007 NWE needs to be aware that a request to continue the lost T&D revenue adjustment approach will need to justify such a request in terms of the costs and benefits of that approach compared to other available methods for addressing the lost revenue disincentive, such as the various forms of decoupling and rate design.

Conclusions of Law

1. The Montana Public Service Commission (Commission) is invested with the full power of supervision, regulation and control of public utilities. § 69-3-102, MCA.

2. NorthWestern Energy (NWE) is a public utility subject to the jurisdiction of the Commission. § 69-3-101, MCA.

3. NWE is a distribution services provider and a default supplier of electricity. § 69-8-103, MCA.

4. The Commission has established an electricity cost recovery mechanism that obligates NWE to file annual Electric Default Supply Tracker filings. § 69-8-210, MCA.

5. NWE prudently incurred the electricity supply costs set forth in this Docket to provide default supply service during the 2004-2005 cost tracking period. § 69-8-210, MCA.

6. Transmission and distribution revenue that is lost due to NWE's acquisition of demand-side resources is a demand-side management or energy efficiency cost. But for the acquisition of demand-side resource, NWE as the default supplier would not lose this revenue. The lost revenue is an actual cost of providing default supply service. NWE may include lost transmission and distribution revenue attributable to its acquisition of demand-side resources in electricity supply costs. § 69-8-103(13), MCA.

7. The Commission may authorize the recovery of lost transmission and distribution revenue on an interim basis subject to true-up and refund. § 69-3-304, MCA and § 69-8-210, MCA.

8. The allowance of recovery of lost transmission and distribution revenue on a temporary basis is necessary and convenient to ensure that NWE provides adequate and reliable default supply services at the lowest long-term total cost. § 69-3-103, MCA and § 69-8-419, MCA

9. The Commission may approve stipulations that settle contested issues. § 2-4-603, MCA.

10. The Commission may determine the value of demand-side resources for rate-making purposes. § 69-3-109, MCA.

11. Any finding of fact that can properly be considered a conclusion of law and that should be considered as such to preserve the integrity of this Order is hereby incorporated as a conclusion of law.

Order

1. The power supply expenses NorthWestern Energy incurred to provide default supply service in the 2004-2005 cost tracking period were prudently incurred.

2. The Stipulation and Agreement and subsequent Addendum between NorthWestern Energy and Montana Consumer Counsel included in this Order as Attachments A and B are approved in their entirety.

3. Pursuant to the Addendum to the Stipulation and Agreement between NWE and the MCC, NorthWestern shall remove revenues of $2,528,488 and purchased power expenses of $4,170,252 associated with the January 2003 Avista sales from this Tracker. This results in a net expense reduction of $1,641,764. This will flow through as an adjustment to the prior period portion of the deferred account in the next tracker Docket No. D2006.5.66.

4. NorthWestern Energy is authorized to recover $920,249 in estimated lost transmission and distribution-related revenue from demand-side resource acquisition, on an interim basis, for the 2005-2006 tracking year. This estimate must be trued-up following a comprehensive program evaluation to verify savings.

5. NorthWestern Energy is not authorized to recover $52,070 of staff labor expense associated with the position of DSM Program Coordinator in this tracker filing. Labor expenses associated with the DSM Program Coordinator should be presented in a general rate case.

6. NorthWestern Energy must file with the Commission on or before June 15, 2007, the results of a comprehensive evaluation, performed by an independent third party, of all demand-side management programs that verifies savings produced by the programs for the evaluation period. NorthWestern Energy must consult with its advisory committee on the selection of the independent evaluator and the proper scope of work.

7. NorthWestern Energy is authorized to include estimated lost transmission and distribution revenue adjustments in annual default supply cost recovery filings for the 2006-2007 tracking year.

8. NorthWestern Energy must, in consultation with its advisory committee, evaluate the costs and benefits of the lost transmission and distribution tracking and recovery mechanism the Commission temporarily approves in this Order from Company, ratepayer and societal perspectives. Based on this evaluation, on or before June 15, 2007, NorthWestern Energy must file a report with the Commission containing a recommendation for proceeding with either a continuation of the lost transmission and distribution mechanism, a modified or alternative mechanism, or no mechanism.

DONE IN OPEN SESSION at Helena, Montana on this 11th day of July 2006 by a vote of 3 - 2.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

GREG JERGESON, Chairman

BRAD MOLNAR, Vice Chairman
(voting to dissent)

DOUG MOOD, Commissioner
(voting to dissent)

ROBERT H. RANEY, Commissioner

THOMAS J. SCHNEIDER, Commissioner

ATTEST:

Connie Jones
Commission Secretary

(SEAL)

NOTE: Any interested party may request the Commission to reconsider this decision. A motion to reconsider must be filed within ten (10) days. See ARM 38.2.4806.